Commercial Law Unit 3 Study notes

The Law of Insolvency

When Studying insolvency, it is important to know what it means to be insolvent. Being insolvent is when you have too much debt and liability, and you cannot pay it back to your creditors (liability is greater than your assets). Being insolvent isn't something you can just call yourself; the court determines if a person is insolvent. It is first recommended that a person goes under debt review before making their way to court. Debt Review is when you go to a debt counsellor, and they determine the best course of action to handle your debt. If they can no longer help you, then you go to court. The court determines if you are insolvent, if you are they will elect you a trustee, the trustee is someone who rehabilitates you, meaning they will help you get out of debt. It is important to note that a trustee is on the creditor's side, and they make sure that you pay them. A trustee's duty is to make sure that you do not recklessly sell things and take on more debt, they become in charge of your estate because you have been classified as someone who is incapable of maintaining your estate. This is my own summary of insolvency; I will go into more detail about the law of insolvency.

Important terms: Sequestration is a legal process where a court takes control of a person's or a company's assets and estate to settle outstanding debts owed to creditors. It is a formal process aimed at distributing the debtor's assets fairly among the creditors to satisfy the debts as much as possible. Sequestration can either be done voluntarily or enforced by the court.

If a person is declared insolvent, they lose capacity. This means that they cannot enter certain contracts such as phone contracts, or lease agreements, if they want to, they must first get consent from a trustee. Being insolvent also prevents a person from becoming a director of a company, these are just a few consequences of being insolvent, there are many consequences that I will touch basis with later.

Meet Steve: Dealing with Insolvency

Steve is a hardworking individual in his early 30s, living in a suburban neighbourhood. He works as a graphic designer and earns a monthly salary of R10,000. Over the years, Steve has accumulated some debts, including a

mortgage on his small house, a car loan from Suzuki, credit card bills, taxes, and utility bills. His total monthly expenses amount to approximately R12,000, leaving him with a deficit of R2,000 each month.

Unfortunately, Steve's financial situation takes a turn for the worse when he loses a freelance project that he was relying on to cover his extra expenses. Unable to find an immediate replacement, he starts falling behind on his payments. The mortgage and car loan are his top priority, but he also struggles to keep up with other bills.

The Debt Collection Process Begins

As the bills pile up, Steve starts receiving letters of demand from various creditors, including Suzuki, asking for immediate payment. Debt collection agencies begin calling him frequently, pressuring him to settle his outstanding debts. Steve feels overwhelmed and anxious, not knowing how to handle the mounting pressure.

Considering Debt Review

In a desperate attempt to regain control of his finances, Steve considers seeking debt review. He approaches a reputable debt counsellor, who conducts a thorough assessment of his financial situation. The counsellor reviews Steve's income, expenses, and outstanding debts to determine the best course of action.

Exploring Debt Review and Debt Repayment Options

The debt counsellor negotiates with Steve's creditors on his behalf, explaining his current financial hardships and proposing a manageable repayment plan. They manage to convince some creditors to reduce interest rates or extend repayment terms, making the monthly payments more affordable for Steve.

Insolvency as a Last Resort

Despite the debt review process and renegotiating some debts, Steve still finds it challenging to make ends meet. The debt counsellor advises him that, as a last resort, he may consider declaring insolvency.

Declaring Insolvency

Steve, after careful consideration and understanding of the consequences, decides to declare himself insolvent. He files for personal insolvency, and the court reviews his case to determine his eligibility. Given his genuine financial hardship and inability to repay his debts, as they fall due, the court accepts his insolvency application.

The Role of the Trustee

Upon being declared insolvent, the court appoints a trustee to manage Steve's estate. The trustee takes control of his assets, including the house and car, with the primary goal of distributing the proceeds fairly among the creditors. The trustee is a neutral party who ensures that both Steve's interests and the creditors' rights are protected during the process.

The Road to Rehabilitation

During the insolvency period, Steve learns valuable financial management skills through mandatory counselling sessions. He attends sessions on budgeting, money management, and debt prevention. As he continues to work and earn a stable income, he contributes a portion of his earnings to the trustee, who then uses the funds to repay the creditors according to their priority.

A Fresh Start

Once Steve completes the insolvency process and settles his debts, he receives a discharge from the court. While his credit score may have been affected, he now has an opportunity for a fresh start. Steve is determined to maintain better financial habits, live within his means, and save for the future, ultimately aiming to rebuild his creditworthiness over time.

Debt management

As we know, insolvency is only a last resort for a person. Just because you can’t pay off a few debts doesn’t make you insolvent. A person should first consider debt management and only if debt management fails should you file for insolvency to the court.

Here are a few remedies before considering insolvency:

1. Debt payment on credit: Borrowing money or using existing credit lines to pay overdue creditors with extended payment deadlines.
2. Debt consolidation: Combining multiple smaller loans into a single loan with lower interest rates, often secured against collateral like a house.
3. Rescheduled debt payment: Requesting creditors to extend repayment periods and reduce monthly instalments, though it may result in more interest.
4. Liquidation of assets: Selling assets to generate immediate cash for debt repayment, mostly used by businesses.
5. Compromise: Liquidating assets to pay secured creditors in full and a percentage of the debt to unsecured creditors, with the remaining balance written off. (Remember bad debts when doing accounting, this is that)
6. Voluntary distribution: Negotiating individual payment plans with each creditor, prioritizing necessary living expenses and secured creditors.

7. Administration order: For debts below R50,000, a debtor may apply to a magistrates' court for an administration order, allowing single monthly payments to an administrator, who then pays pro rata to unsecured creditors every three months.
   Once an administration order is in place, the debtor cannot incur further debts without notifying the other party, and unsecured creditors cannot take legal action against the debtor during the order's duration. The court may sell specified assets based on the application's hearing.

Purpose of the insolvency act

I explained this earlier but let me say it again, just because a person cannot pay off a few debts does not make that person insolvent, to be insolvent the high court must declare that you are insolvent. The person is insolvent because they have more liabilities than assets.

Creditors have various remedies for seeking payment from debtors. If a summons receives no response, the creditor can obtain a court judgment and a warrant of execution to attach and sell the debtor's assets at auction, using the proceeds to reduce the owed amount.

Other options include seeking payment in instalments or using garnishee proceedings to order an employer to deduct payments from the debtor's salary. The court can also order payment from other sources of income. A creditor is also able to use the insolvency act.

The insolvency act has 3 purposes:

1. To ensure that sequestration is to the advantage of creditors.
2. After insolvency proceedings, to release a debtor from future liability for their debts by rehabilitating them (teaching them to be wiser with their money)
3. To protect creditors against the possible greed and untruthfulness of other creditors.

The estate of a debtor can be sequestered voluntarily or could be forced to surrender their estate by the court.

The Difference between a curator bonis and a trustee

In summary, a curator bonis is appointed to manage the financial affairs of an incapacitated individual, while a trustee is appointed to manage and administer assets in a trust for the benefit of the trust's beneficiaries. The roles and duties of both the curator bonis and the trustee revolve around handling financial matters, but the contexts in which they operate are different.

Reasons why a person may voluntarily surrender:

- To halt legal proceedings and to end the harassment by creditors and debt collectors.
- To stop paying creditors for years of legal fees of the creditor's attorneys' collection Commission and interest.
- Creditors are sometimes unwilling to compromise and reduce interest and give a person a longer period to pay, to make it more manageable for a person, this is another reason to voluntarily surrender.
- You may just want an impartial person to distribute your assets equally amongst creditors.
- You may want to voluntarily surrender to avoid paying unjustifiable amounts because you made bad business decisions.
- You might just want to start fresh and have a clean break so you consider to surrender your estate.

The procedure for voluntary surrender

Involves the debtor seeking to sequestrate their estate due to insolvency voluntarily. To satisfy the court, the applicant must meet several requirements:

Notify Creditors: The applicant must take steps to notify creditors of the application, giving them an opportunity to object.

Insolvency: The applicant's estate must be insolvent, with liabilities exceeding assets.

The advantage to Creditors: Sequestration must be advantageous to creditors, and an independent valuation of immovable property or assets may be required.

Sufficient Assets: There should be enough assets to cover the costs of sequestration.

Before applying, the debtor must publish a notice of surrender in the Government Gazette and a local newspaper, complying with specific timeframes. The notice cannot be withdrawn without the Master's consent.

After publication, attached property cannot be sold without authorization, depending on its value. The Master may appoint a curator to take control of the debtor's estate.

Within seven days of publication, the debtor must deliver a copy of the notice to each creditor and provide a detailed affidavit and statement of their affairs to the Master.

The affidavit must include personal information, marital status, assets, and liabilities, as well as reasons for insolvency and a demonstration that the sequestration will be advantageous to concurrent creditors.

The key distinction between voluntary surrender and compulsory sequestration applications lies in the debtor's assertion that the sequestration "will be to the advantage of creditors" rather than merely having "reason to believe that it will be to the advantage of creditors."

Compulsory sequestration

The creditor must provide detailed information about the amount, cause, and nature of the claim, indicating whether it is secured. They also need to submit an affidavit outlining the debtor's insolvency or the act of insolvency. The applicant must notify the Master of the High Court and provide a certificate of sufficient security for the application's costs.

Upon receiving the notice of the application, the debtor (if an employer) must inform the registered trade union representing employees and display the notice at the workplace. The court may issue a provisional sequestration order if it believes the creditor has a valid claim of insolvency, and the order would benefit the creditors. This order will include a rule nisi, calling on the debtor to explain why the estate should not be finally sequestrated on a specified return date.

If the debtor fails to show cause on the return date, the court will issue a final sequestration order. Before the liquidation or sequestration, the creditor may be approached to support the nomination of specific trustees, liquidators, or auctioneers and may choose to intervene to support or oppose the application.

Before the court can grant a compulsory sequestration order, it must be convinced that the debtor has committed an "act of insolvency." Proving an act of insolvency is sometimes easier than proving actual insolvency.

The Act provides a list of events that qualify as acts of insolvency, which include:

1. The debtor intentionally absences themselves from their dwelling or South Africa to delay or evade debt payment.

2. The debtor fails to satisfy a court judgment, and the deputy sheriff finds insufficient assets to cover the judgment.

3. The debtor tries to dispose of the property in a way that harms creditors or gives preference to one creditor over others.

4. The debtor attempts to remove property to the detriment of creditors or to favour one creditor over others.
5. The debtor offers an arrangement to a creditor that would release them partially or entirely from their debts.
6. After publishing a notice for estate surrender, the debtor fails to submit the required documents on time or at all.
7. A trader gives notice in the Government Gazette about selling their business but becomes unable to pay their debts.
8. The debtor informs any creditor in writing that they are incapable of paying any of their debts.

The final sequestration order is a court order that initiates the formal process of insolvency. Once the court grants the order, the registrar sends copies of it to various authorities, including the Master of the High Court, who publishes it in the Government Gazette, and relevant officials such as sheriffs, registrars of deeds, and officers in charge of ship registers.

The appointed sheriffs prepare a list of all movable property belonging to the insolvent estate and share the inventory with the Master and the trustee. Additionally, the registrars and ship officers make a notation (caveat) against any title deeds to prevent the transfer of immovable property owned by the insolvent estate.

The final sequestration order must be served on the insolvent and their spouse. The insolvent is required to provide all records of their financial affairs to the person serving the notice. Both the insolvent and their spouse must deliver a statement of affairs to the Master within seven days.

After the final sequestration order is issued, any civil legal proceedings involving or against the insolvent are halted until a trustee has been appointed to handle the insolvency process.

THE TRUSTEE

The Act takes away the insolvent debtor's control over their estate and transfers it to a trustee. This transfer stops all civil proceedings related to the debtor's debts.

The property of the insolvent's spouse is also transferred to a trustee, but any property that belongs to the solvent spouse remains unaffected. The purpose is not to burden the solvent spouse with the insolvent's debts but to prevent fraudulent transfers of assets to the solvent spouse to avoid creditors.

In some cases, the trustee or liquidator needs the consent of creditors to continue the insolvent's business. This process involves negotiations and discussions as different parties vie for appointments and try to protect their interests.

Creditors who have registered their contact information with the trustee or liquidator should receive notices of creditors' meetings. However, the first meeting of creditors is typically organized by the Master of the High Court, and even the trustee or liquidator may not be aware of the exact date of the meeting in many cases.

The trustee plays a crucial role in the insolvency process. When a debtor becomes insolvent, the Act appoints a trustee to take control of the debtor's estate. This includes all movable and immovable property, books, documents, and even the debtor's business affairs.

The trustee's responsibilities involve initiating debt recovery proceedings against those who owe money to the insolvent estate. They manage an estate bank account and receipt book, and with authorization from creditors or the Master, they may continue the insolvent's business.

At the first meeting of creditors, one or more trustees or liquidators are elected by the majority of creditors who have proved their claims. The trustee investigates the debtor's business affairs and reports to creditors at the second meeting.

During the process, creditors have to prove their claims, and in certain circumstances, may be required to contribute to administration costs if the estate's funds are insufficient.

Creditors have the right to inspect documents lodged and may also interrogate the insolvent under oath regarding financial matters.

The trustee's role includes collecting all assets and, if necessary and instructed by creditors, challenging certain transactions entered by the insolvent before sequestration.

The appointment of the trustee ensures a collective approach among creditors (concursus creditorum) and safeguards the rights of all creditors without allowing any single creditor to alter or prejudice others' interests. The trustee acts as a central figure in managing the insolvent estate and ensuring a fair distribution of proceeds among creditors.

These are various types of transactions that may be set aside by the court, either upon the application of the trustee or a creditor in the name of the trustee:

1. **Dispositions without value**: Any transaction, like a donation, made by the debtor without receiving anything in return can be set aside by the court. If the disposition occurred more than two years before sequestration, it will be set aside only if it is proven that the debtor's liabilities exceeded their assets right after the transaction. If the disposition was made within two years of sequestration, the recipient must prove that the debtor's assets were greater than their liabilities after the transaction.

2. **Voidable preferences**: The law aims to treat all creditors equally. Thus, any transaction by the debtor that favours one creditor over others, and was made within six months of sequestration, may be set aside by the court if the debtor's liabilities exceeded their assets after the transaction. However, if the debtor can prove that the transaction was a regular business transaction and not intended to prefer any creditor, the court may not set it aside.

3. **Undue preference to creditors**: If the debtor disposes of property at a time when their liabilities exceed their assets, and with the intention of favouring one creditor over others, the court may set aside the transaction. To succeed in court, the applicant must prove both elements of undue preference.

4. **Collusive dealings before sequestration**: The court can set aside a transaction that harms creditors or unfairly benefits one creditor over others if it was collusively arranged.

5. **Voidable sale of a business**: A trader can only sell their business after publishing a notice in the Government Gazette and two newspapers in the area, between 30 and 60 days before the sale. Failure to do so makes the sale void against creditors for six months. If the trader's estate is sequestrated within six months of the sale, the sale is also void against the trustee during that period.

6. **Set-off**: If a person offsets any debt within six months before their estate is sequestrated, the trustee may either accept the set-off or demand the other party to pay the debt to the estate

The trustee's main responsibility is to sell the assets of the insolvent estate as quickly as possible. The Act includes detailed provisions for holding meetings of creditors, where creditors give directions to the trustee on matters related to the administration of the estate and their voting powers.

After selling the assets, the trustee must distribute the proceeds among the creditors based on the order of preference set out in the Act. Secured creditors are paid first, and the remaining amount, known as the free residue, is used to satisfy the claims of unsecured creditors.

The order of preference for secured creditors includes different types of liens and mortgages depending on whether the asset is immovable (e.g., real estate) or movable (e.g., personal property).

For unsecured creditors, the order of preference for payment from the free residue includes death expenses, sequestration costs, execution costs, statutory debts, employee salary portions up to certain limits, taxes, and general mortgage bond claims, among others.

If an employer is sequestrated, all employment contracts are suspended until the trustee decides whether to terminate them. During this period, employees would not have to work, but they wouldn't be paid or receive benefits. However, employees can claim unemployment benefits immediately.

The trustee must consult with relevant parties before making decisions on employment contracts to try and save the business or part of it. Creditors may participate in the consultation if the trustee agrees. Terminated employees can claim severance benefits as per the Basic Conditions of Employment Act.

The next important step is for the trustee or liquidator to prepare the liquidation and distribution account. Once approved and dividends are paid to creditors, the account is final and cannot be reopened. Creditors should inspect the account and object if they disagree.

After the distribution of assets and payment of dividends, the insolvent may apply for rehabilitation, which puts an end to the sequestration and relieves the insolvent of pre-sequestration debts and disabilities. If no action is taken, the insolvent is automatically rehabilitated after ten years from the date of sequestration, unless the court orders otherwise.

The effect sequestration has on the insolvent.

When an individual becomes insolvent, their estate includes all their property at the time of sequestration (bankruptcy) and any property they acquire during the bankruptcy process. Once a court grants a sequestration order, the relevant authorities are notified to prevent improper transfers of immovable property belonging to the insolvent estate. The deputy sheriff is responsible for attaching and making an inventory of the movable property of the insolvent estate that can be physically delivered and is not already under someone else's possession or attachment. If the creditor wants the property to be stored securely, only the deputy sheriff can arrange for that. Any interested person can witness the attachment process. The deputy sheriff then submits a detailed report to the Master (a court official overseeing the case) and provides a copy of the inventory to the trustee (the individual responsible for managing the insolvent estate).

Rights of the insolvent

As an insolvent, certain rights are restricted to protect the interests of the creditors and the proper administration of the insolvent estate.

1. Disposal of Property: The insolvent is not allowed to sell or transfer any property belonging to the insolvent estate. Any contracts that could adversely affect the estate are voidable by the trustee, meaning the trustee can choose to cancel them. The insolvent can only sell or transfer property acquired after the sequestration with the consent of the trustee.

2. Employment and Business Restrictions: The insolvent may continue with their profession or occupation, but they need written consent from the trustee to be employed or involved in the business of a general dealer, manufacturer, or certain specific businesses like building operations, public entertainment, or hotel-keeping. They are not allowed to engage in the production of finished articles from raw materials.

3. Legal Proceedings: The insolvent can sue or be sued in their own name for matters relating to their status or rights that do not affect the insolvent estate. They can sue without involving the trustee for pensions, compensation for injuries or defamation, and professional work remuneration. However, they can also be sued in their own name for any delicts (torts) committed after sequestration, for which the insolvent estate is not liable.

Duties of the insolvent

The duties of the insolvent are obligations and responsibilities they must fulfil during the process of sequestration to ensure a fair and orderly distribution of assets among creditors.

1. Non-Payment to Creditors: If an individual becomes aware that their estate is likely to be sequestrated, it is their duty not to favour any specific creditor by making payments to them. The insolvent must preserve their assets for equal distribution among all creditors. Failure to comply with this duty may lead to criminal prosecution, and the payment made to a specific creditor may be considered an undue preference and set aside.

2. Keeping Records: The insolvent must maintain detailed records of all assets received and disbursements made during their profession, occupation, or employment. They need to submit monthly statements to the trustee.

3. Assisting the Trustee: Before the second meeting of creditors, the insolvent must help the trustee in realizing any property belonging to the estate. In return, the trustee must provide the insolvent with an allowance in money or goods sufficient to support the insolvent and their dependents, as determined by the Master.

4. Attendance at Meetings: The insolvent must attend all meetings of creditors if required to do so by the trustee. Failure to attend may result in imprisonment.

5. Interrogation: Creditors have the right to ensure that an interrogation of the debtor takes place to ascertain the extent and location of any remaining assets. Creditors themselves may be called as witnesses during the interrogation. Legal representation during the interrogation may or may not be allowed depending on certain circumstances.

Effects of sequestration on the property of the solvent spouse

Under the Insolvency Act, the property of the solvent spouse may be affected if one of the spouses becomes insolvent. Section 21 of the Act vests in the trustee of the insolvent's estate all the property of the solvent spouse unless proven otherwise. This provision applies to spouses married out of community of property. The solvent spouse can apply to the court to exclude certain property from the effects of Section 21, provided they can safeguard the interest of the insolvent estate in that property.

The solvent spouse can claim their own property by submitting an affidavit to the trustee, supported by relevant documents. The trustee must release any property that the solvent spouse can prove was theirs before the marriage, acquired through valid antenuptial contracts, or obtained in ways that are valid against creditors.

However, certain circumstances might lead to the property being considered part of the insolvent estate, such as donations between spouses or using the insolvent's money to purchase property in the solvent spouse's name.

The trustee can sell the property only after providing a six weeks notice to the solvent spouse and following certain publication requirements. The solvent spouse can challenge the trustee's decisions in court, but the burden of proof lies with them.

Termination of insolvency

Termination of insolvency, also known as rehabilitation, marks the end of the sequestration process and relieves the insolvent from their debts. There are several scenarios under which an application for rehabilitation can be made to the court:

1. The creditors have agreed to a settlement offer (composition) and the insolvent provides security for 50% of the settlement amount.
2. All proved claims, including interest and costs, have been fully paid.
3. After six months from sequestration, no claims have been proved against the insolvent estate.
4. After 12 months from the Master's confirmation of the first account, and the Master recommends rehabilitation, provided there is no previous sequestration and no convictions for fraudulent acts related to the insolvency. If convicted of fraud, the application can be made after five years from the conviction date.
5. After four years from the date of sequestration.

The court application must be accompanied by an affidavit, stating that the insolvent has surrendered the estate and made no promises to anyone against opposing the application. The insolvent must disclose their assets, liabilities, dividends paid to creditors, and total claims proved at the date of the application.

The trustee reports relevant facts to the Master, and the Master, trustee, or creditors may oppose the application. The court decision is not automatic and requires a full disclosure of all relevant facts. The court may refuse, postpone, or grant rehabilitation subject to conditions.

If no court order is issued within ten years from the sequestration date, the insolvent is automatically deemed to be rehabilitated.

To summarise we discussed various aspects of insolvency, sequestration, and the rights and duties of the insolvent and the trustee. Here is a summary of the key points:

1. Insolvency and Sequestration: Insolvency refers to a situation where an individual or business cannot meet its financial obligations. Sequestration is the legal process through which the estate of the insolvent is taken over by a trustee appointed by the court.
2. First Meeting of Creditors: At the first meeting, creditors prove their claims, lodge a power of attorney, and may become liable to contribute to administration costs if the estate's funds are insufficient. Creditors also elect one or more trustees or liquidators to manage the estate.
3. Concept of Concursus Creditorum: On insolvency, a collective of creditors comes into existence known as concursus creditorum, where creditors with conflicting interests pursue their claims against the debtor's property.
4. Duties of the Trustee: The trustee takes control of all assets, investigates the insolvent's business affairs, starts debt recovery proceedings, and reports to creditors. The trustee must arrange for the sale of assets and distribute proceeds among creditors based on the order of preference.
5. Effects of Sequestration on the Insolvent: The insolvent cannot dispose of estate property or enter into contracts that adversely affect the estate without the trustee's consent. However, the insolvent retains certain rights, including the ability to carry on a profession or occupation and sue or be sued for certain matters.

6. Termination of Insolvency: Rehabilitation is the process that ends the sequestration and terminates the insolvent's debts. Various conditions and timeframes determine when an insolvent can apply for rehabilitation.

7. Effects of Sequestration on the Property of the Solvent Spouse: Section 21 of the Insolvency Act vests all the property of the solvent spouse in the trustee, and the solvent spouse must prove certain property is their separate property. The solvent spouse may apply for the exclusion of certain property or claim their own property.

Overall, sequestration is a legal process that aims to fairly distribute the assets of an insolvent estate among creditors and eventually rehabilitate the insolvent individual or business, thereby relieving them of their debts.